

SHORT TERM REVERSIONARY TRUSTS

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One of the most highly regarded income tax saving devices currently in circulation is the so-called short term reversionary trust under which the grantor can reacquire the principal free and clear of the trust after a relatively short period where the income during the period of the existence of the trust is payable to others. That it should be regarded as an achievement from a tax point of view to avoid the imposition of a tax on the grantor on income that he could not possibly obtain may seem strange to those uninitiated in the mysteries of income tax jurisprudence or to those unaccustomed to the stern doctrine stemming from the Supreme Court decision in *Helvering v. Clifford*, 309 U. S. 331 (1940). That decision dealt with an intra-family arrangement whereby the income was irrevocably payable for a five-year period to the spouse of the grantor. In the wake of the extraordinary amount of litigation stimulated by that decision most taxpayers and their advisors were willing to take shelter from the judicial chaos in the enclave finally created by Section 29.22(a)-21 of Regulation 111, usually referred to as the "Clifford Regulations," which endeavored to mark out by a metes and bounds description the areas in which the Commissioner treated income as taxable and those which he conceded to the taxpayer. These regulations, however arbitrary in their drawing of the precise lines, had at least the advantage of certainty insofar as the Commissioner's intentions were concerned and furnished an area in which taxpayers could operate in the field of the irrevocable short term reversionary trust.

Under those regulations, the grantor had to part with the income for a period of ten years, or where certain administrative powers were reserved, for a period of fifteen years, if he would avoid being taxed on the income during the period. After the original promulgation of the regulations, they were amended by Treasury Decision 5567 on January 30, 1947, to concede that the grantor would not be taxed on the income of a trust where the income was payable to a named person for the life of such person, regardless of the life expectancy of such person at the time the trust was created. The principles established by the Clifford Regulations pertaining to short-term reversionary trusts were enacted with some modifications by the 1954 Code, Section 673 specifying the circumstances in which the grantor is to be treated as the owner of a reversionary trust. That it was intended that this should be the exclusive provision dealing with reversionary trusts for income tax purposes is evident from Section 671 which, in effect, states that Subpart E (which includes Section 673) is controlling rather than Section 61. The latter defines gross income in those instances where the grounds for including

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the taxing of the income of a trust to a grantor is based upon his dominion and control. It will be recalled that the Supreme Court in the *Clifford* case relied upon the broad statutory definition of gross income now found in Section 61.

GENERAL RULES FOR TAXATION OF
SHORT TERM REVERSIONARY TRUSTS

Ordinary Income

The statutory test for taxing the grantor is whether the reversionary interest "will or may reasonably be expected to take effect in possession or enjoyment within ten years commencing with the date of the transfer of that portion of the trust." Accordingly, we may conclude that the grantor is not taxed by reason of the retained reversionary interest where he has not retained a reversionary interest in the corpus or income which "will or may reasonably be expected to take effect in possession or enjoyment" within a period of ten years measured from the date of the transfer to the trust. In the normal case the reversionary interest would be a reversionary interest in the corpus. This need not necessarily be so since the grantor of a trust may only have a life estate and so far as Section 673 is concerned, the grantor would not be taxed if he created a trust under the terms of which the income from the trust became payable to a beneficiary for a period of ten years.

It should be noted that Regulation 1.671-1(c) states that Sections 671-678 of the code do not apply "in situations involving an assignment of future income, whether or not the assignment is to a trust." In the regulations cited, the example is used of a bondholder who assigns his right to interest being taxable on the interest payments even though the assignment is to an uncontrolled trust.

The statute also follows the Clifford Regulations in permitting the grantor to retain a reversionary right where the reversionary interest does not take effect until the death of the person or persons to whom the income is payable. The life that must be measured under this exception is that of the income beneficiary and a reversionary interest retained after the death of A, where the income was payable to B during the life of A, would not qualify unless the expectancy of A was greater than ten years. However, if the income were payable to B during the life of B, the income would be taxed to B and not to the grantor even though the life expectancy of B was less than ten years.

Sometimes the grantor may wish to provide for an aged beneficiary by providing that such person receive the income from the trust during life, but may wish to protect himself by terminating the trust at the end of a term of years, not less than ten, if the life beneficiary still survives and the funds are needed by the grantor in his old age. This can be done since Regulation 1.673(c) makes it clear that the trust will qualify even though the trust terminates on the first to occur of the expiration of ten years, or the death of the income beneficiary. Frequently, a

grantor may hesitate to part with the income of the trust because of the fear that during the ten year period the funds might be needed to support his minor children where, for example, through misfortune or business reverses, his earning capacity is substantially diminished, and might wish the income from the trust to be used for the support of his children rather than the person who would otherwise receive the income during the ten year period or during life. It is clear that under Section 677 this income would be taxed to the grantor in the event it were so used. This, however, would not be a serious matter if the only reason for its being used were the immediate needs of the dependent children arising from the inability of the grantor to support them from his other funds. In that event grantor would presumably be in a low income tax bracket and would have more serious problems than tax ones.

Capital Gain Income

One problem which is encountered frequently in practice is that with respect to capital gains. It is entirely possible that the grantor may be contemplating the use of low base assets as the corpus of the trust and during the course of the existence of the trust it might be advisable or even the duty of the trustee to sell such assets. The effect of the basis provisions of Section 1015 would, of course, be to create income in the trust by reason of the sale, and in the event of capital gains being treated as corpus under the trust instrument, as would normally be the case, such income would be taxable to the grantor since it is income which would pass to the grantor upon the expiration of the trust; and since it is income which is held for future distribution to the grantor, it would be taxable to him under the general rule established by Section 677(a)(2). The grantor may be faced with a substantial tax liability which may be difficult for him to meet from assets outside the trust. The burden of the tax could, of course, be shifted from the grantor if the capital gains of the trust were payable to the income beneficiary of the trust since they would be taxable to such beneficiary under the general rule. Whether capital gains is a significant problem will, of course, depend upon the basis of such assets in the hands of the grantor. The solution of the capital gains problem by giving the capital gains to the beneficiary gives rise to additional problems in respect to gift taxes discussed *infra*.

Special Rule with Regard to Charitable Beneficiaries

One new feature in the short term reversionary trust area is the unusual privilege afforded to taxpayers under Section 673(b) who, for the benefit of charitable beneficiaries, create a trust of the type to which contributions qualify for the additional ten per cent deduction under Section 170(b). In this case, the period is shortened from ten years to two years and the effect of this section is to permit an unlimited deduction of income from income producing property where such property is placed in a two-year trust.

Illustration from Assumed Facts

Under the assumed facts, the domestic situation of Mr. Beaver provides an apt illustration for the substantial income tax savings that can be effected through the use of a short term reversionary trust. It will be noted that Mr. Beaver has been supporting his mother-in-law, age seventy-five, and a married daughter, age twenty-three. Assuming that Beaver had been expending \$2,500 a year for the support of each, or a total of \$5,000, it would mean that in view of the assumed current income tax bracket of Beaver, he would have required annually \$15,000 of income before taxes. In other words, Beaver would have to have \$15,000 of income to pay \$5,000 to his daughter and mother-in-law and the \$10,000 of income tax on said \$15,000. If Beaver set aside income producing property yielding \$5,000 annually in a short term reversionary trust, the income of the trust would be taxable to the beneficiaries and not to Beaver. It is true the beneficiaries would have to pay the tax on the \$2,500 they received, but this would be a small amount if this were their only income and Beaver might lose a dependency deduction of \$600 if he had been entitled to it. Disregarding the dependency deductions, it is evident that by creating the trust, income tax savings to Beaver are so substantial that after parting with the income of \$5,000 a year he would end up with approximately \$3,000 more income after taxes and gifts than he had prior to the transfer—a striking illustration of the phrase that in income tax matters it is sometimes “more blessed to give than to receive.”

Estate Taxes and Gift Taxes

The short term reversionary trust is of limited usefulness in reducing estate tax liability since in the nature of things the retained reversionary interest will be includable in the estate. However, in the example cited above of the creation of the trust for the benefit of the daughter and mother-in-law, in the event of the death of Beaver prior to the expiration of either of the trust periods, the property that would be includable in the estate is not the value of the corpus of the estate, but the value of the reversion. In some cases the entire value of the corpus will be included in the estate, *e.g.*, where the gift is created in contemplation of death.

The more immediate problem than the estate tax problem is the gift tax problem since the creation of the short term reversionary trust does result in a taxable gift of property for a term of years or a life estate, and where the reversionary right is dependent upon the grantor surviving the beneficiary, the grantor has disposed of more than the income interest.

As noted above, in the event capital gains are payable to the income beneficiary, it is entirely possible that the effect of such provision would be to give the income beneficiary substantially more than the value of an ordinary right to receive income from the trust. No precise method of

evaluating the possibility as to what the income beneficiary might receive is possible, and from a practical standpoint it would appear that the gift should not be treated as having been completed until the securities are sold and the amount then payable can be measured. It cannot be contended, however, that the law is settled on this point.

SELECTION OF TRUSTEE

The question frequently arises as to whether the grantor may act as a trustee in a short term reversionary trust without endangering the income tax advantages of a reversionary trust. Such a trust is, of course, subject to the statutory rules of Subpart E. In general, there is no requirement in Section 673 relating to reversionary interests which would exclude the grantor's acting as trustee and it is frequently desirable for the interest of the family as a whole that the grantor serve as trustee. If such a course is chosen, care must be taken that the trust does not become taxable by reason of a power which the grantor would have as a trustee to control its beneficial enjoyment or by reason of the prohibited administrative powers named in Section 675. Where there is no power to change the disposition of the income during the period and where the administrative powers are not of the kind prohibited in Section 675, the grantor may serve as trustee. However, there are many cases where the grantor desires to obtain some measure of flexibility in a short term trust by vesting in the trustee certain discretionary rights, *e.g.*, in the distribution of income. In some cases such a trust would be taxable to the grantor where he served as trustee under Section 674 and an independent trustee may be required.

FIVE-YEAR THROWBACK RULE

Commonly, the five-year throwback rule will not be applicable in the case of the short term reversionary trust even though the trust provides for the accumulation of the entire income during the term of the trust since the time at which the accumulated income becomes payable would normally exempt the trust from the application of the throw-back rule; *i.e.*, the final distribution being more than the nine years after the date of the last transfer to the trust as specified by Section 665(4). A provision frequently seen in the ordinary family trust arrangement is a power in the trustee to accept additional contributions to the trust and in the event an additional transfer is made to a short term reversionary trust within nine years from the termination, the effect would be to destroy the exemption from the throwback rule.